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SEC ADOPTS NEW RULES TO ADDRESS NAKED SHORTING AND OTHER SHORT SALE PRACTICES

On September 17, by Emergency Order, the Securities and Exchange Commission amended existing rules and adopted new rules designed to address “naked” short selling and other short sales effected for an improper purpose. While certain of these rules had previously been under consideration, clearly, the Commission was motivated by recent market events including severe declines in the market price of financial service stocks this week and a perceived threat to fair and orderly markets. These rules became effective almost immediately upon announcement, at 12:01am this morning, Thursday, September 18.

I. New Temporary Rule Mandating Settlement or Close-Out

First, the Commission adopted, on a temporary basis, a rule mandating timely settlements of both long and short sales and imposing close-out conditions and other restrictions on broker-dealers that fail to deliver on such sales. The presumed objective of the rule is to preclude naked shorts and thereby prevent the downward spiral that can result from the momentum of unfettered, delivery-free sales. The settlement and close-out rule, Rule 204T under Regulation SHO, contains the following key provisions:

- The requirement to close-out fail positions is satisfied at the time of the purchase of the subject securities (i.e., on T+4) and at the time the transaction is settled (which would occur regular-way on T+7). **Note:** this same rule does not apply to close-out trades necessary to remove the broker-dealer from the “penalty box” as described below.
 - If the fail results from a short sale, the broker-dealer must close-out the fail by buying securities when trading begins on the day after settlement (i.e., on T+4).
 - If the fail results from a long sale, the broker-dealer must close-out the fail by buying securities when trading begins on T+6. (The broker-dealer, of course, will need to confirm through its books and records that the sale was a long sale).
 - If the fail results from a sale of restricted or control stock pursuant to Rule 144 under the Securities Act of 1933 (a “Rule 144 sale”), the rule provides additional time for the issuer’s transfer agent to process the sale and remove any restrictive legends. Fails from such Rule 144 sales must be closed-out by T+39.

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- The requirement to close-out fail positions is satisfied at the time of the purchase of the subject securities (i.e., on T+4) and at the time the transaction is settled (which would occur regular-way on T+7). **Note:** this same rule does not apply to close-out trades necessary to remove the broker-dealer from the “penalty box” as described below.
- If the broker-dealer does not comply with the close-out provisions described above, the broker-dealer may not accept **any** customer’s short sale for the subject security or effect a short sale in that security for the broker-dealer’s own account. Effectively, the broker-dealer enters “the penalty box.”
- While in the penalty box, the broker-dealer must borrow, or enter into an arrangement to borrow, the subject security. This “pre-borrow” requirement is similar to the requirement imposed during the Commission’s prior Emergency Order in July. An ordinary “locate” (that is, relying upon a list of borrowable securities or determining whether securities are generally available for borrow) is not sufficient. **Market makers in the penalty box are not exempt from this requirement.**
- The broker-dealer remains in the penalty box until it closes out its fail position by purchasing securities and that purchase has cleared and settled. Thus, the steps necessary to exit the penalty box are more onerous (an additional settlement cycle delay) than the steps necessary to avoid being placed in it.

II. Elimination of Options Market Maker Exception

Rule 203(b)(3) of Regulation SHO previously provided an exemption to the Reg SHO requirement to close-out certain positions in threshold securities. The Emergency Order permanently removes this exemption, effective immediately, even for fails occurring prior to the effectiveness of the Order.

III. New Naked Short Antifraud Rule

The Commission also made immediately effective Rule 10b-21 under the Securities Exchange Act of 1934, a rule that had been proposed previously. Unlike the other rules, which apply directly only to broker-dealers,

this rule applies to all sellers (including broker-dealers selling as principal). The rule makes it a “manipulative or deceptive device or contrivance” under Section 10(b) and Rule 10b-5 for anyone to submit an order to sell an equity security if (a) that person deceives a broker-dealer or clearing agency with respect to the person’s ability or intention to deliver the security by settlement date **and** (b) the person fails to deliver the security by settlement. The Commission makes clear that Rule 10b-21 complements, and does not limit or restrict the applicability of, Section 10(b) and Rule 10b-5. Interestingly, the rule does not appear to capture the inappropriate practice of a naked short sale which does not fail because the customer, for example, quickly repurchases the security same-day at a lower price. Broker-dealers should be alert to these and other practices even if beyond the rule’s reach.

Broker-dealer customers, particularly hedge funds, should take particular note of Rule 10b-21. Regulation SHO currently allows a broker-dealer executing a short sale for a customer to rely upon that customer’s reasonable representation that the customer has borrowed the security and will deliver it for settlement. A hedge fund customer, for example, might advise an executing broker that it located the subject securities through its prime broker. Under new Rule 10b-21, if a customer now makes such a representation to its broker-dealer, but has not in fact performed the locate, the *customer* may be held liable, presuming all the other elements of fraud, including scienter, if the sale fails. Institutional customers should therefore take care not to represent cursorily or simply as a matter of rote that it has “located” or borrowed securities without being clear that it has done so.

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The Commission’s Emergency Order is also significant for what it did not impose, particularly given the current market turmoil and volatility. The Commission did not re-impose the “tick test” or any other price or selling constraint. Also, it did not impose the onerous “pre-borrow” requirement mandated on a temporary basis by the Commission’s prior Emergency Order. Nevertheless, as indicated by recent press reports, short sale regulation remains a controversial issue, and it is not immediately clear whether additional short sale rulemaking will be proposed.

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